COMPLETING THE REFORM OF OUR BANKING SYSTEM

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Any change in the economic practices of a nation of such vital importance as the adoption of a new banking system and the consequent changes in banking and commercial credit practices, which will undoubtedly be involved, must require some reasonable time for the adjustment of the minds of those most directly concerned —the bankers.

This remains true, notwithstanding the thoroughly known fact that we have been working towards this change for some years, and the further fact that the law finally enacted was discussed from one end of the country to the other. Its principles are understood, but it is the practical working of the law which is now being studied.

The national banks were swept into the new system by operation of law, but they constitute a minority of the banks of the country, both in numbers and resources. What magnitude the development of the federal reserve system will attain will therefore depend upon the entry of the state banks.

What is the present attitude of the state banks? The liberty-loving people of this Republic are impatient of either restraint or regulation of their personal or business affairs, and their experiences with excesses of regulation of business within the last ten years have not deadened their sensibilities, but the contrary. Regulation is yet on the increase. *Organization of bank resources* is far more the keynote of the federal reserve system than regulation, but it seems clear that the thought of regulation is at present the cause of hesitation on the part of state banks, particularly the large state banks.

It matters not that the national banks may have been regulated to their own good and the good of the country, and that state banks in some of the states are now strictly regulated. It is combined regulation, or too much regulation which is feared.

One of the purposes of the Federal Reserve Act set forth in its title is to "establish more effective supervision of banking in the

United States"—the vital importance of which no sound banker, state or national, will pretend to dispute. It has been made plain by rules promulgated by the Federal Reserve Board relating to the admission of state banks into the system, that the purpose of the Board is to establish that "effective supervision" with respect to state banks, rather than attempt to accomplish that much broader and more restrictive purpose conveyed by the word "regulate."

In my judgment the distinction is one to be borne in mind in the development of the federal reserve system. The utmost freedom in banking consistent with soundness should be permitted in this country with its broad expanse of territory, its widely varying interests, and its different local practices. It is organization for the common good and effective supervision which should be aimed at, with no more regulation than is necessary, and the division of the country into federal reserve districts under managements elected by the member banks of each district, with a central supervision, is a highly practical plan, well designed to accomplish the purpose.

Notwithstanding the reasons here put forward it still remains a matter of wonder that what is clearly the most beneficial piece of financial-commercial legislation ever enacted in this country has not met with more instant recognition and adoption by banks generally. The public has been quick to see the benefits which have come and are yet to come, and that being so, as I believe, banking recognition will inevitably follow.

It has been the deliberate opinion in this country that the independent local bank is the most effective agent to minister to the financial needs of the community, small or large. Whether this has been an economic mistake, or whether it could have been better done by a branch banking system, I will not undertake to argue. The multitude of small banks, however, increases the difficulty of gathering them into a unified system and will probably delay that greatly to be desired end, which may nevertheless come sooner than is now anticipated.

The credit and the currency principles of the Federal Reserve Act are so sound, and the provision for concentration of the huge reserves of the banks for common use contains within itself such manifest benefits, heretofore unattainable; such mighty power for development and stability; such assured protection for the banks and the trade of the nation, as to command the patriotic coöperation

of all bankers, and such coöperation will without doubt in due course be rendered, and cannot fail to be in the interest of the banks themselves.

It is not a matter of theory, or mere optimistic forecast, but of deliberate, cold calculation, based upon our own past experiences, to determine the power which the organized and the concentrated reserves of the banks of this country (and of our huge gold supply constantly growing, over which our banking system should give us control) must exercise in the development of our credit resources, in stabilizing our interest rates and in warding off our currency panics, and when we reflect upon our progress during the past quarter century under grave and well recognized handicaps it may well stagger the understanding to consider what, with our improved banking machinery in full working order, may reasonably be within our reach in commerce and finance in the near future. There is no question in my mind that this will take hold upon the thoughts of the bankers of the country and bring their support to the system.

We now occupy a truly wonderful position with respect to the rest of the world. Our money and credit resources and our food and other material supplies are superabundant. The opportunity is given to supply the rest of the world from our abundance, not only the nations at war, but those countries which have heretofore been supplied by the nations at war. Never in the life of this nation has such an opportunity been presented, and it is not reasonable to look for its repetition.

It is time to perfect our banking and commercial machinery with a view to that which must come after; a time to prepare for the extension of our commerce within and without the country; to prepare our manufacturing plants for competition and to rehabilitate our transportation industries. Opportunity does not twice knock as it is now knocking at the door of this country.

The important powers conferred upon federal reserve banks and contemplated by the act, in addition to the ordinary functions of banking, are these:

1. Note issue.
2. Assumption of the fiscal agency and general banking functions of the government.
3. Establishment of foreign agencies and international dealings.
4. Supervision over member banks.

Among the new and important powers and privileges granted to the member banks by the act are these:

1. The privilege of converting bills receivable into reserve by rediscounting with the federal reserve banks. This gives them the use of that portion of their reserves required to be kept with the reserve banks.
2. The power of acceptance in commercial transactions involving the importation and exportation of goods.
3. The limited power to establish foreign branches.

The early development of the federal reserve system will be along these lines. It is not believed to be expedient for the reserve banks to enter foreign fields for any purpose under present conditions.

One of the most important developments that should come from the development of the system is the simplification and unification of our currency. It is not practicable within the limits of this article to enter into details of how this may be done, but it should be and will be accomplished, in my judgment.

Some few amendments to the act are doubtless desirable. They are practical in their nature. To my mind it is of very great importance that the full provisions of the Federal Reserve Act should be put in force at the earliest date practicable, and without waiting for the gradual changes during the three year term provided in the act, two years of which have yet to run. It is of such seeming importance, and involves so many details of the practical working of the system, that I have confined this article chiefly to an argument in favor of an amendment to that effect.

There is now afforded the best opportunity this country has ever had, and, so far as human foresight can determine, in the light of experience, the best opportunity it can ever hope to have to complete the regeneration of its banking system. Moreover, if undertaken now, no risk will be incurred, but on the contrary, there will be put into action the most effective means within our command to correct a situation which, by almost common consent among experienced bankers, contains a growing menace, and from which we can hardly otherwise hope to emerge without a repetition of some of the evils which have been the outcome of similar situations in times past.

The enormous and continually-piling-up bank reserves under the combined effect of the new system, and the overlapping operation

of the old, afford a supply of credit far beyond any sum ever before made available in this country. Human nature has never heretofore been able to resist using too abundant bank resources for speculation and inflation, and we cannot reasonably expect it to resist the present opportunity, even under the restraining influences of present world-conditions. *As a direct result of the Federal Reserve Act* in its first period of operation, the volume of credit which the banks could legally grant, based upon the reserves held, was enormously increased at a time when an increase was needed as never before. The subsequent growth of these reserves to such a remarkable extent has been due to causes well understood; but the diminished percentage of reserves now required to be held is the chief cause of the enormous apparent excess of reserves shown.

The following table will illustrate in a graphic manner, far better than verbal description, the entire reserve position of the banks, and the change which will be brought about by putting the act in full operation at the present time.

The figures are made up from the Comptroller's statement of May 1, 1915. The latest statement available would be that of June 23, but the labor involved in readjusting the figures to that date would be very considerable, and would not better serve the purpose of illustration. It is sufficient to say that a statement of current date would show still more exaggerated conditions.

DEPOSITS REQUIRING RESERVE

Compiled from the Comptroller's Statement, May 1, 1915

Central Reserve Banks	Reserve City Banks	Country Banks	Total
$2,032,000,000	$2,035,000,000	$3,130,000,000	$7,197,000,000

RESERVES NOW HELD

	In vault	In federal reserve banks	Total held in vaults and federal reserve banks	Balances with other banks	Total reserve held
Central reserve cities..........	$356,978,000	$154,415,000	$511,393,000	....	$511,393,000
Reserve cities	173,049,000	65,475,000	238,524,000	$294,314,000	532,838,000
Country banks ...	209,110,000	74,848,000	283,958,000	454,382,000	738,340,000
	$739,137,000	$294,738,000	$1,033,875,000	$748,696,000	$1,782,571,000
Legal reserve required to be held..........					1,054,710,000
Excess reserve..........					$727,861,000

NEW RESERVES REQUIRED UNDER FULL OPERATION OF THE ACT

Central reserve cities 6–18......	$121,925,000	7–18 $142,246,000	$365,775,000	....	....
Optional 5–18	101,604,000	....	....	....	....
Reserve cities 5–15	101,769,000	6–15 122,123,000	305,307,000	....	....
Optional 4–15	81,415,000	....	....	....	....
Country banks 4–12..........	127,876,000	5–12 159,845,000	383,628,000	....	....
Optional 3–12	95,907,000	....	....	....	....
	$630,496,000	$424,214,000	$1,054,710,000	....	$1,054,710,000

Amount of balances with other banks which would be eliminated from reserves if the act were put into immediate and full operation.................................. $727,861,000

It is of course well understood that part of the reserve which some of the national banks were required to maintain could under the old law be kept on deposit with other national banks located in the reserve and central reserve cities.

As will be seen in the foregoing statement these balances with other banks amounted to $748,000,000 or more than the entire amount of *surplus* reserves.

The Federal Reserve Act provides that these balances shall be gradually withdrawn over a period of three years, to the extent necessary to provide the cash required, both in bank vaults and in federal reserve banks and after that time nothing will be allowed to count as legal reserve except cash in bank, or balances with federal reserve banks.

The amount of these balances necessary to be withdrawn for transfer to the federal reserve banks and to provide the cash reserve required is about $157,000,000, which would still leave on deposit with other banks the difference between that amount and the $748,000,000 shown above, or $591,000,000. But this huge sum remaining on deposit will not be allowed to count as legal reserve, as hereinbefore stated.

It is very plain, therefore, that the new law will eliminate an immense sum of bank credit from the legal reserves of banks as heretofore maintained. It was of course designed to accomplish this purpose.

Now, while the amount of reserves "released" at the inauguration of the system was about $450,000,000, the amount which will be

eliminated when the act goes into full operation will be about $727,000,000—the calculations being based upon existing conditions. If, therefore, within the next two years, bank loans should become expanded in any measure approximating the limit possible *upon the present basis of reserves,* the contraction which will be brought about by putting the act into complete operation cannot fail to cause distress.

If, upon top of this, as the end of the period approaches, and in the event of the ending of the war, the other nations take measures—which they undoubtedly will then be able to take—to recover the gold which they have been compelled to send us, and which they will be needing badly to put their own financial houses in order, the situation will be still more gravely complicated.

Since both of these eventualities are to be seriously reckoned with, it becomes a matter of very grave consequence to consider *whether the act should be at once amended so as to enable all of its reserve provisions to be put into immediate effect* while it can be done with ease and benefit. It is almost certain that when the time approaches to put the act in operation, given conditions of inflation or even legitimate absorption of surplus reserves on a large scale, opposition to it will arise, because of the contraction which must ensue; and that fact will be a powerful argument to postpone, if not defeat, the completion of the act. The sound credit and reserve provisions were put in the act only after many years of preparation and effort and against all kinds of opposition. To have to compromise now upon any important principle, after victory has been won, would be a calamity.

It has been reported that at the recent convention of the American Bankers' Association a resolution, approved by the Administrative Council, was submitted and passed advocating the attempt to procure an amendment to Section 19 of the act to permit country banks to keep "4 per cent of their reserve with any national bank in a reserve or central reserve city—." If this means a reserve of 4 per cent on the amount of their deposits—as it was doubtless intended to mean—it would be a sum of one-third greater than the "optional reserve" required to be held under the act, and would involve $128,000,000, if calculated upon present deposits.

Such a provision would be a dangerous weakening of reserves, especially when coming upon top of the reduced requirements, and

would be a sacrifice of the principle of the act and bring discredit upon the system. It would also be a decided step towards that inflation of which some bankers have already accused the act.

The passage of this resolution will serve to illustrate the dangers the act will inevitably have to run while going through its various stages of development. At each change opposition of some character is likely to arise. At the time the federal reserve banks were launched it would have been impossible, without disaster, to make the adjustments required to put the act into full operation. The amount of cash held by the banks was then short of actual requirements by $134,000,000, and the amount which would have been required to make the adjustments back and forth between reserve and central reserve and country banks would have caused a much heavier deficiency before final adjustments could have been accomplished *and no reserves would have been released.* Rediscounting, of course, could have been resorted to in order to make up the deficiency in cash, but severe disturbance would have followed in any event.

SHOWING WHAT WOULD BE THE AMOUNT OF RESERVES REQUIRED UNDER THE OLD LAW, AND THE PROPORTION OF THE AMOUNT NOW HELD WHICH COULD BE COUNTED AS LEGAL RESERVE

	Central reserve cities	Reserve cities	Country banks
Reserve required ..	(25%) $508,000,000	(25%) $500,000,000	(15%) $443,300,000
Legal reserve.......	511,396,000	492,546,000	558,418,000
Excess..........	$3,396,000	Def. $7,454,000	$115,118,000
Net excess.......	....	....	111,060,000
Excess balances with agents, not allowed to count as reserve:			
Reserve cities	....	....	37,000,000
Country banks...	....	....	187,800,000
Excess reserves under present law.	....	....	$727,861,000
Difference between old and new excess reserves ...	....	....	$616,801,000

Conditions now are radically different, and the act can now be put in full operation with far greater facility than that with which the initial transfers were accomplished.

To illustrate the extent to which the act in its present chrysalis stage is responsible for existing huge legal bank reserves, it is highly illuminating to examine into what would be the reserves under the old law. This is shown in the table below:

It is interesting also to compare the above statement with the condition of the banks on October 31, 1914, just prior to the opening of the reserve banks.

STATEMENT SHOWING THE RESERVE CONDITION OF NATIONAL BANKS OCTOBER 31, 1914

	Central reserve cities	Reserve cities	Country banks
Reserve required	$411,255,000	$484,083,000	$537,910,000
Reserve held	409,204,000	455,619,000	576,484,000
Excess or deficit	Def. $2,051,000	Def. $28,464,000	Excess $38,574,000
Net excess			8,059,000
Excess balances with agents, not allowed to count as reserve: Country banks			111,420,000
The reserve city banks held an excess in cash of			20,520,000
But were short in their reserve with agents			48,984,000
Making the net shortage in their reserve, as above			28,464,000

It is reasonably clear upon the face of things that the act could now be put in complete operation without disturbance or injury to finance or commerce, and with benefit to the member banks in steadying interest rates—now thoroughly demoralized and endangering profits.

The condition of federal reserve banks after readjustment would be about as follows:

LIABILITIES

Capital stock—Statement September 11	$54,772,000
Reserve Deposits—Minimum required after adjustment	424,714,000
Federal Reserve notes—net	17,527,000
All other liabilities	3,068,000
	$500,081,000
The amount of "optional reserves" required be to carried by the banks either in their own vaults or in federal reserve banks would be	$278,926,000

It is reasonable to suppose that some portion of these reserves will be carried in federal reserve banks.

Government deposits have not been considered, although the banks now hold $15,000,000 of such deposits.

It has been shown that a return to the old law would have the effect of reducing excess bank reserves from $727,000,000 to $111,-000,000. Putting the reserve provisions of the act into immediate operation, as illustrated in the foregoing, would, therefore, have about the same effect upon member bank reserves as a return to the old law, but with this vital difference that *the huge resources of the reserve banks would be available for the grant of additional credit to the country, and this flexible reserve would be under concentrated control, with the ability to regulate the credit situation to an extent now wholly beyond the power of the banks or the Reserve Board.* While a very large amount of legal reserves will be eliminated, they are *surplus reserves*, not needed, performing no service, a source of embarrassment and possible danger—and may be the direct means, by lowering the interest rate too greatly, of expelling gold later on to countries able and willing to offer more for it.

It was the direct purpose of the act to eliminate from reserves, balances due by other banks, at a time when it might be safely done, and for that purpose the provisions of the act were so framed as to be brought into operation gradually. An extraordinary condition has arisen under which it may safely be done at once and with profit.

It therefore appears that, given a situation when the act can easily and safely be put into operation, not only with benefit, but as a safeguard against evils almost certain otherwise to arise, and when delay may even mean defeat of the deferred provisions of the act, the present opportunity should not be permitted to pass without action.

The following benefits may be reasonably expected to follow from putting the act in complete operation:

1. It will insure the accomplishment of the reserve provisions, which may be endangered by delay.

2. By eliminating a huge amount of legal, but fictitious, reserves it will be using the most effective means at command to safeguard against undue expansion which all previous experience has taught us is likely to occur.

Inordinate expansion at this time would probably be attended by exaggeration of many troubles which have hitherto afflicted us, and by a string of evils peculiar to the circumstances arising from war conditions. The economic effects which must come from the extensive use of the credit now made available—the effect upon prices, the cost of living, the condition and wages of labor at a critical time when labor has been made unusually scarce by the war, are all to be considered. The most conspicuous phase of current conditions is the labor situation in industries made phenomenally prosperous by war business, here and abroad—"A little leaven will leaven the whole lump."

3. It will give the reserve system a better control over the credit situation of the country.

4. It will benefit member banks by steadying interest rates, and will go far to insure profitable, but always reasonable, rates. Cheap credit and excessively low rates have an element of danger. It will take from member banks a large amount of bank deposits, but at a time when they are not profitable, and it will be no hardship to give them up. Conditions might change and opposition arise.

5. By eliminating an unreal surplus, it will insure to the reserve banks a better income by creating a more active rediscount demand. Member banks having to borrow will be more than compensated by the better rates they will be enabled to charge.

6. It will aid more than any other factor in solving the collection problem of the reserve banks. With reduced balances, member banks will probably not find it profitable to continue making collections free of charge, and the reserve banks will be called upon for that service.

7. By having better control over interest rates, and with a well developed collection system, the power to draw state banks into the system will be greatly increased. If substitution of federal

reserve notes for national bank notes can be made in a wholesale way, then by having measurable control over interest rates, with a superior collection system and the exclusive power of note issue, the attraction to state banks should be such as to give early hope of a "unified system."

8. The greater strength of the reserve banks will give them increased control over the gold supply.

Contrary to the argument advanced in certain quarters, the issue of reserve notes indirectly against gold has no concern with the provisions of the act intended to give flexibility to the currency, and cannot by the substitution of one dollar for another create an inflated currency. Flexibility can be created by the addition or withdrawal of a relatively small surplus, and is affected by redemption laws more than by any other cause.

The reserve banks by this process have accumulated a reserve supply of credit, available under certain conditions. The greater their accumulation of gold in this or any other way, the greater the protection to our supply. The strength of the reserve banks is to be measured by their gold holdings and consequent note issuing power. In whatever way the control over the gold supply and the interest rate can be placed in the hands of the reserve banks, or under concentrated control, it should be done. The foreign financial problem will become ours after the war.

Since August 1, 1914, the following changes have taken place in the foreign banking situation:

	August, 1914	July, 1915	Increase
Bank of England:			
Gold holdings	$190,000,000	$260,000,000	$70,000,000
Deposits	335,000,000	1,035,000,000	700,000,000
Bank of France:			
Gold holdings	825,000,000	785,000,000	40,000,000(d)
Deposits	260,000,000	485,000,000	225,000,000
Circulation	1,335,000,000	2,440,000,000	1,105,000,000
Bank of Germany:			
Gold holdings	420,000,000	590,000,000	170,000,000
Deposits	235,000,000	400,000,000	165,000,000
Circulation	470,000,000	1,300,000,000	830,000,000
Bank of Russia:			
Gold holdings	800,000,000	785,000,000	15,000,000(d)
Deposits	420,000,000	750,000,000	330,000,000
Circulation	730,000,000	1,750,000,000	1,020,000,000
The total increase in gold holdings is	....	....	185,000,000
And the increase in deposit and circulation liabilities	....	....	4,375,000,000

(d) decrease.

The contest for the gold supply will be keen, and the countries with the highest interest rates and the greatest need will act as suction pumps on the supply.

9. To put the act into full force at once will remove a source of unsettlement which the frequent changes can hardly fail to cause, and will tend to quiet the disposition to criticise and amend it. It will also lead to a quicker and more comprehensive appreciation of its aims and purposes, and promote a better understanding of sound credit and banking. It will put to rest the frequent accusation that the act is the cause of inflation. If it is not done, the accusation may become a true one.